

2003 annual report



the art of safety

a message from the chairman



On behalf of the Board of Directors, I am pleased to introduce Montana State Funds' Annual Report for FY 2003. Montana State Fund (MSF) operates in a very dynamic and competitive environment. Our success in the past and our continued progress in the future are dependent upon our ability to anticipate and respond rapidly to service expectations and industry change.

This was a challenging year as the insurance industry coped with price increases to customers, declining investment income, and increased losses. Through it all, MSF employees have remained focused on delivering the best product and service possible to policyholders and their injured employees. We understand the critical role we play in the economic and social well being of the citizens of our state. It is a responsibility that we gladly accept, and it's what separates us from the other insurance carriers that operate in Montana.

On a regular basis, the board of directors and I have the opportunity to work closely with the employees of MSF. We admire their dedication and professionalism. The MSF team is focused, dynamic and innovative. It's a pleasure to be able to work in tandem with these committed individuals as they continue to meet the ever-changing needs of Montana businesses.

We know that maintaining a strong and viable workers' compensation system is crucial to our present and future economic development efforts. Moving forward, our vision will be our guide.

We thank you for your continued support.

A handwritten signature in black ink, reading "Herbert Leuprecht". The signature is written in a cursive, flowing style.

Herbert Leuprecht, Chairman

president's message

By any measure, FY03 was a challenging time for workers' compensation insurers. A combination of rising medical costs, decreased investment income, higher reinsurance rates, and increases in claim losses resulted in declining profits and upward pressure on pricing. And, with Montana comprising a mere 4/10 of 1% of the national workers' compensation market, we were strongly impacted by national trends.

This was also a year of great change at Montana State Fund (MSF). In February 2003, Carl Swanson stepped down as President/CEO of our organization. Carl served in his position for nine years, leading MSF through some very turbulent times. I believe that the benefits from the changes he instituted have made us what we are today. He helped instill in MSF a new culture that transcends any one individual. It is a culture of performance and excellence. It's what sets Montana State Fund apart from our competitors.

For the first time since FY92 we experienced a net operating loss. The primary cause of our negative operational results is from prior years' adverse loss development beyond that anticipated in our rates and pricing for those years. Over the past

3 years we have observed adverse development on our claims that exceeded actuarial predictions.

The primary factors driving costs upward include:

- Higher medical expenditures
- Legislative changes and Supreme Court decisions resulting in increased benefits
- Declining income from investments
- Federally mandated terrorism insurance coverage

What we experienced is not without precedence. Industry experts estimate that nationally workers' compensation companies are 7% under-reserved on claims and many carriers are strengthening their reserve estimates and recording operating losses. Our surplus absorbed these adverse losses and we have taken immediate and effective corrective steps to reign in claim costs and anticipated future costs in our rates and pricing strategies. It is because of our strong financial position that we are capable of weathering these losses, and it underscores the need for MSF to

maintain adequate reserves and surplus into the future.

The Art of Safety

While the recent trends are disturbing, the fact remains that Montana loss costs are still 32% lower than they were in 1995. Experience has shown that the insurance market is cyclical in nature. We know that the current cost burden and profitability factor is a worry for all workers' compensation carriers, and MSF is no exception. In this type of environment, it becomes incumbent on all of us to do what we can to prevent accidents in the workplace from occurring in the first place and emphasize early return to work and modified duty programs. As you will read throughout this report, we have committed our corporate energies to fostering safe work environments. Clearly, an investment in workplace safety is a key factor that can help control rising insurance costs.

A competitive state fund must be a stabilizing force in the marketplace. When times get tough in the insurance industry, carriers often find it necessary to retrench to concentrate their resources in their core markets. In the past several years, we've

seen carriers withdraw, leaving Montana businesses with fewer available options for purchasing workers' compensation coverage. It is of paramount importance to the businesses and citizens of Montana that there is a reliable, stable workers' compensation system in place for this essential and mandatory coverage. Montana State Fund has a responsibility to employers to be fiscally sound because they have passed over all the liability under the workers' compensation law to us. We also have a tremendous responsibility to injured employees and the medical community to have sufficient money set aside to pay for medical care and lost wages.

Legislative Highlights

FY03 was also busy on the legislative front. As a quasi-governmental entity, the ultimate authority for MSF lies with the legislature. During the August 2002 special session, SB19 was enacted resulting in a transfer of \$4 million from the excess in the Old Fund to the state's General Fund. Up until then, any excess in the Old Fund was transferred to the New Fund in recognition of the \$167 million that New Fund policyholders had

paid to help retire the Old Fund Liability Tax. SB19 also created an interim study committee to make recommendations to the 58th legislature on a restructuring proposal for MSF. It is our belief that the operation of a competitive state fund is a unique activity for state government, and that a public corporate structure, rather than that of a state agency, is more appropriate to allow us to serve our customers in an efficient manner. This proposal was brought to the legislature in the form of SB153, but missed the transmittal deadline.

With the state facing a serious fiscal imbalance, there were bills introduced to transfer policyholder surplus to the General Fund. We were joined by a coalition of organizations from around the state in opposing these measures. Surplus is intended to assure that an insurer will be able to fulfill its obligations to policyholders and injured employees, and cannot be viewed as public funds. Instead, SB360 passed with bi-partisan support and prohibits MSF assets (New Fund) from being transferred to other state programs or the General Fund. This was an important step taken to preserve the integrity of policyholder surplus, and was one of the major goals

we had set out to accomplish in our initial legislative proposal.

HB363 transferred \$18.1 million from the Old Fund to the general fund. It did so by removing the 10% contingency fund that had been required in existing law (\$9 million), and transferring the remaining excess funds from FY02 (\$9.1 million). While the Old Fund still remains actuarially sound, there are no reserves available to deal with unforeseen crises or retroactive court decisions that would impact benefit payments. Montana State Fund administers the Old Fund on behalf of the legislature. As a result of the actions taken in this bill, any future shortfall in the Old Fund is the responsibility of the state General Fund.

Finally, SB304 created an interim committee to study the feasibility of selling the state fund and/or creation of an assigned risk pool as well as looking at our role in the workers' compensation system in our state. It is our belief that we will be able to demonstrate the importance of a competitive three-way system to the committee, and look forward to the opportunity of participating in these discussions during the interim.

Serving Montana

We recognize that service is only as good as the last customer contact. On the corporate level, we are directing our energies to create an environment in which our customer service maintains consistency in handling policy matters, responds to questions and requests in a timely manner, with courteous and knowledgeable front-line staff. By teaming together, we are striving to teach our customers how to minimize their exposure, while creating a positive working environment for their employees.

The current hard market cycle is a test for all workers' compensation carriers, and MSF is no exception. By maintaining our financial strength and stability, we can continue to deliver the highest quality workers' compensation insurance at competitive prices. Montana State Fund is a dynamic organization that is constantly fine tuning itself to maintain our status as Montana's insurance carrier of choice and industry leader in service.

Ultimately, it is our vision that differentiates us from other workers' compensation insurers in Montana. We exist solely to provide Montana

employers and their employees with competitively priced coverage, no matter what challenges face the insurance industry. Our vision focuses on our commitment to the health and prosperity of our state. It goes to the core of who we are, and is the key to our ongoing success.

In closing, I would be remiss if I did not express my appreciation to the Board. During my years at Montana State Fund, I've had the opportunity to work with our Board of Directors. These dedicated businessmen and women come from across Montana and fulfill the responsibility entrusted to them by the legislature to oversee the operation of Montana State Fund. I appreciate their willingness to take time away from their own businesses and families to serve our organization. They are to be admired for their dedication to public service on behalf of the citizens of our state.



Laurence Hubbard
President/CEO





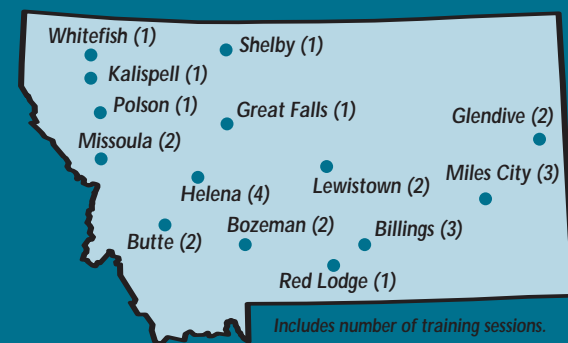
painting the picture

The “art of safety” for any business takes time, patience, commitment, creative thought and follow-through. But once the canvas has dried, and a company’s safety picture is complete, it can lead to lower premium costs, fewer accidents, improved employee morale and productivity, and overall bottom line savings. It takes a cast of talented individuals to craft an effective workplace safety program. Our policyholders, their employees, MSF claim adjusters, customer service representatives, underwriters and safety service consultants all play a role in this creative venture.

our artists

MSF’s 262 employees are constantly weaving a message of safety into their daily contact with employers and injured employees. Our inspiration comes from the fact that we are committed as an organization to the health and economic prosperity of Montana. MSF’s safety “masters” are our safety management consultants (SMCs). Through one-on-one appointments and readily available information, the SMCs draw on their experiences to help our customers shape their own individual safety programs. We have strategically located SMCs throughout the state to provide superior customer service. In FY03 1,597 policyholders were visited by a SMC. This is a 16% increase from the previous year.

Locations of Safety Trainings FY03



revitalizing a safety landscape

A shot-off finger, a partial left-leg amputation and a dozen horse-related accidents were enough to raise a red flag for MSF Team 1 Leader Nance Hughes. These accidents had all taken place over the past two years at Hardin, Montana's annual Custer Re-enactment event. Hughes knew that the Hardin Chamber of Commerce, the policyholder for the Re-enactment, had to make safety their number one priority for the upcoming June 2003 production. She was concerned about the welfare of the 200-plus participants in this living history performance and the Chamber's skyrocketing premium costs.

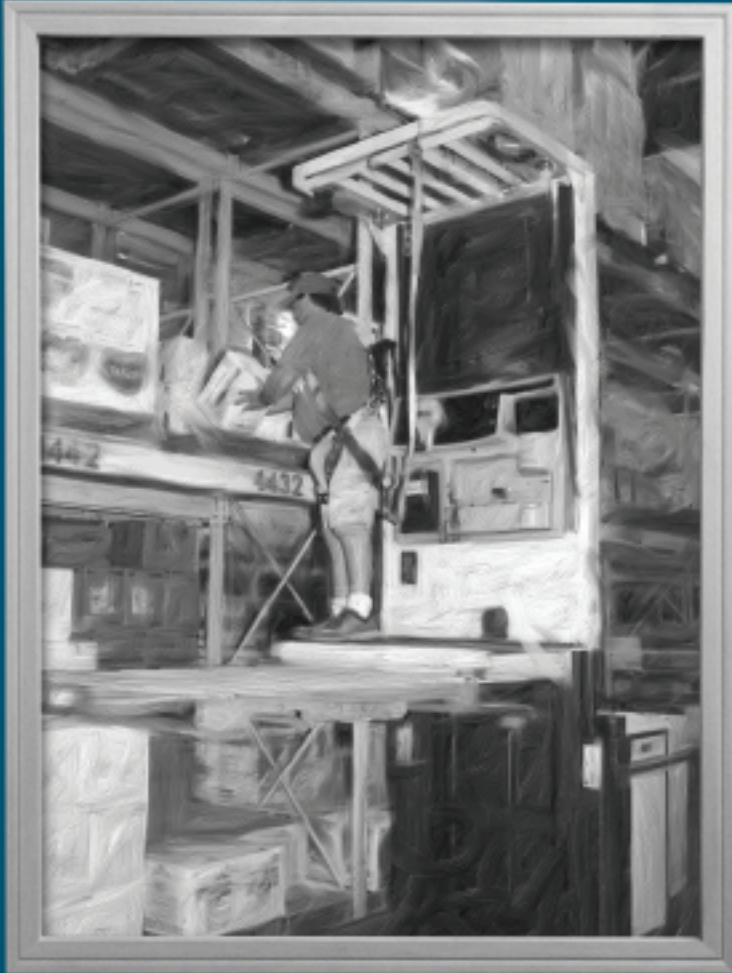
"We contacted the chamber's Board of Directors and had a meeting with them," said Hughes. "After some discussion we agreed to assist them with safety as long as the commitment was there from them."

It was agreed upon by all the participants that safety was critical for the success of the Re-enactment. Throughout the weekend of the event, MSF's staff constantly reminded participants to focus on safety. After each of the show's performances, the key cast members and the director reviewed and discussed how to make the next performance safer.

According to John Dahl, Custer Re-enactment Chairman, this year's event was the beginning of something good. "I sincerely feel that the efforts of MSF in scrutinizing our show and looking for ways to make it a safer environment have laid the foundation for forging a new attitude among all of the volunteers and re-enactors. The committee and I have already held a couple of meetings to discuss finding a qualified Safety Director for next summer's production."



a lasting impression



It's fair to say that the workers at the Department of Revenue's liquor warehouse in Helena deserve a toast. The employees implemented an aggressive safety program that helps them avoid any incidents on the job. Sandy Lang, the statewide facilities officer for the Department of Revenue, says that the whole process started after she attended an MSF-sponsored safety training.

"I went to one of the safety training classes on job hazard analysis and after the session I thought the liquor warehouse would be a good place to start the process."

What Lang started was a whole new way of thinking at the warehouse. Bill Susag is the Liquor Warehouse Floor Boss. He says looking at their business practices opened their eyes to some real safety issues.

According to Lang, the training she has received from MSF has been very beneficial. "I just think these trainings make us more aware and I think that is what happened here. It made people start thinking about what they can do to avoid an accident."

Susag agrees. "I think it has worked out wonderfully. This is a lot safer place to work and that's my main concern; I don't want to see anyone get hurt."

impressionism

First impressions count. For many Montana employers, their first impression of MSF may be at one of our free safety seminars. Our workshops have been created to give business owners the tools they need to fine-tune their own safety plans. These seminars are open to all employers, not just MSF policyholders. In FY03, over 400 Montana employees attended trainings in 26 communities. Some of the seminar topics included: Bottom Line Safety; Job Safety Analysis; Reducing Unsafe Acts; Emergency Preparedness; Hiring Employees Who Value a Safe Work Environment; Office Safety; and Job Hazard Analysis.

self portrait

A company's investment in a safe, productive workplace is no accident. Because unsafe behavior contributes to more than 90% of all injuries, it's essential that businesses commit themselves to promoting the development of a safety culture throughout their organization. By taking responsibility for their own safety environment, policyholders have the opportunity to mold a program that is compatible with their business needs.

This year \$3 million in dividend payments were awarded to 92% of our customers with superior safety records. This was our fifth consecutive dividend for qualifying policyholders. This is money that stays in Montana and is put back to work in our communities. Dividends are just one of the ways that companies benefit from good safety habits. The greatest reward comes with the satisfaction of knowing that safe workplaces contribute to the well-being of all.

working to heal

One way policyholders can lower premium costs and boost employee morale is through the creation of an effective Early Return to Work (ERTW) program. The ERTW program is a tool that employers use to get their injured employees back to the workplace to perform meaningful, productive work within the realm of their physical capabilities. Our redesigned ERTW manual, "Working to Healing" is a vehicle that helps our customers fashion their own ERTW program. The manual is available in print or electronic format.



expressionism

Expressing our safety message to our policyholders, injured employees, insurance agents and the public is key to our organization's success. We accomplish this through advertising, newsletters, the Internet and informational brochures.

Over 30,000 policyholders, medical providers, insurance agents and other interested parties receive our newsletter *Perspectives*. This quarterly publication illuminates issues of safety and relevant workers' compensation information.

Open communications with our partnering independent Montana insurance agents is essential. We keep agents abreast of critical issues through the quarterly electronic newsletter *Partnership Update*. More timely topics are quickly sent in the form of the electronic Partnership Alert.

The Internet has become an essential tool for us to use in getting our safety message out to the public. As 88% of our customers have Internet access, we make every effort to provide updated information on programs and services available to them on a 24-7 basis.



STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND SURPLUS

as of June 30,

ADMITTED ASSETS

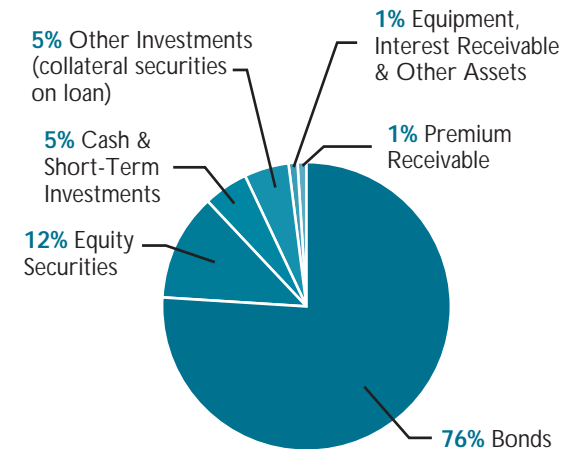
	2003	2002
INVESTMENTS		
Bonds	\$436,818,298	\$415,322,318
Equity Securities	69,958,153	64,180,639
Cash and Short-Term Investments	32,150,786	22,034,873
Other Investments - Collateral Securities on Loan	30,968,721	57,563,169
Total Investments and Cash	<u>569,895,958</u>	<u>559,100,999</u>
OTHER ADMITTED ASSETS		
Premium Receivables	7,354,843	7,365,247
Equipment (net)	815,820	842,983
Interest Receivable	6,586,054	6,441,102
Other Assets	186,713	1,173,510
Total Admitted Assets	<u>\$584,839,388</u>	<u>\$574,923,841</u>

LIABILITIES AND SURPLUS

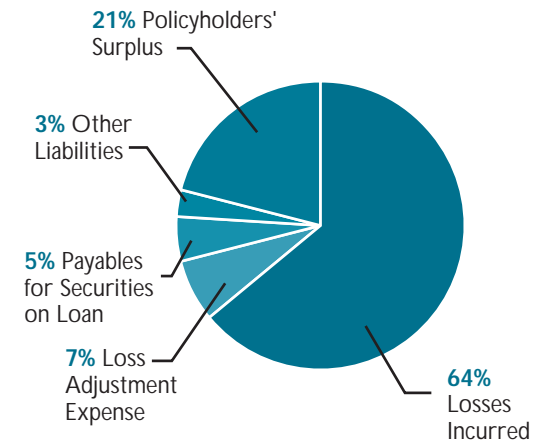
LIABILITIES		
Losses Incurred Reserves	\$372,300,000	\$308,700,000
Loss Adjustment Expense Reserves	41,100,000	37,700,000
Liability for Securities on Loan	30,968,721	57,563,169
Deferred Revenue	202,912	583,980
Other Liabilities	18,668,338	11,877,697
Total Liabilities	<u>463,239,971</u>	<u>416,424,846</u>
CONTINGENCIES AND SUBSEQUENT EVENTS		
SURPLUS		
Policyholders' Surplus	121,599,417	158,498,995
Total Liabilities and Surplus	<u>\$584,839,388</u>	<u>\$574,923,841</u>

Complete audited financial information is available at www.montanastatefund.com or upon request.

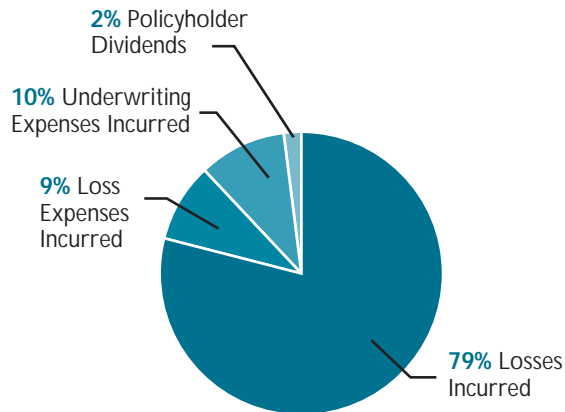
FY2003 ASSETS



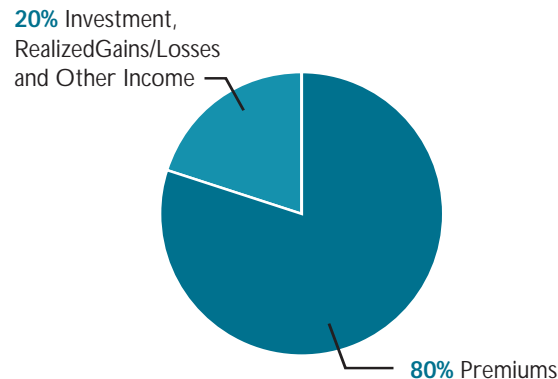
FY2003 LIABILITIES & SURPLUS



FY2003 EXPENSES & TRANSFERS



FY2003 REVENUE



STATUTORY STATEMENTS OF OPERATIONS AND CHANGES IN SURPLUS

for the years ended June 30,

	2003	2002
Net Premium Earned	\$117,776,580	\$92,971,868
Losses Incurred	(146,912,095)	(86,699,328)
Loss Expenses Incurred	(16,074,946)	(12,883,989)
Underwriting Expenses Incurred	(17,559,701)	(15,024,225)
Net Underwriting Loss	<u>\$(62,770,162)</u>	<u>\$(21,635,674)</u>
Net Investment Income Earned	26,799,946	29,112,843
Net Realized Capital Gains (Losses)	2,126,151	4,351,624
Premium Balances Recovered (Charged Off)	(686,078)	(445,304)
Other Income	16,796	411,018
Net Income (Loss) Before Dividends	<u>(34,513,347)</u>	<u>11,794,507</u>
Policyholder Dividends	<u>(2,949,597)</u>	<u>(4,001,224)</u>
Net Income (Loss) After Dividends	<u>(37,462,944)</u>	<u>7,793,283</u>
Prior Year End Surplus	158,498,995	150,879,539
Net Unrealized Gains (Losses) on Equity Securities	777,514	(9,523,024)
Change in Nonadmitted Assets	(156,802)	4,223,294
Cumulative Effect of Change in Accounting Principle Due to Codification	-	(2,242,469)
Aggregate Write In for Gains (Losses) in Surplus	(56,058)	(14,140)
Transfer In (Out), net	<u>(1,288)</u>	<u>7,382,512</u>
END OF PERIOD SURPLUS	<u><u>\$121,599,417</u></u>	<u><u>\$158,498,995</u></u>

Complete audited financial information is available at www.montanastatefund.com or upon request.

REPORT OF MANAGEMENT

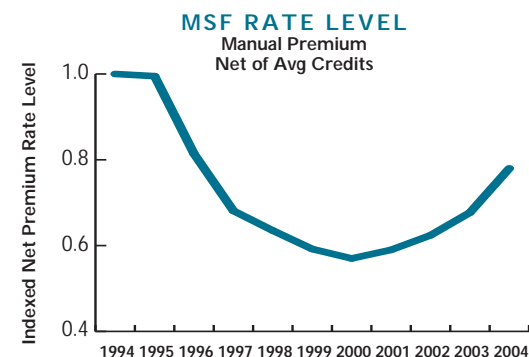
The management of Montana State Fund (MSF) is responsible for the financial statements and all other information presented in this Annual Report. MSF maintains a system of internal control designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. This system encompasses the organizational structure, selection and training of personnel, communication and enforcement of policies and procedures, and ongoing internal and external audit programs. Internal controls are continually reviewed and evaluated by management.

The financial statements are presented for our fiscal year ending June 30, 2003 and 2002 and include amounts based on the best estimates and judgments of management. These financial results are presented on a statutory basis, which is consistent with insurance industry financial statement presentation. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana, and its financial statements are presented on the basis of accounting practices prescribed or permitted by the Montana Insurance Department.

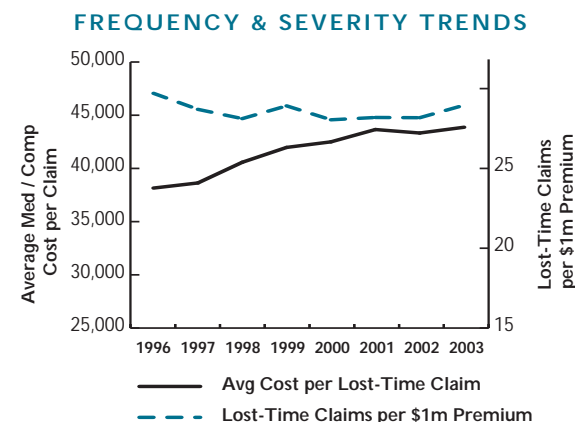
The statements included in this annual report should not be considered complete audited financial statements. The statements presented are representative of audited financial statements as audited by Galusha, Higgins & Galusha, an independent public accounting firm. Galusha, Higgins & Galusha issued an unqualified opinion on MSF's statutory financial statements. The complete audited financial statements including the accompanying notes are available upon request. The preparation and independent external audit of statutory financial statements is discretionary on the part of MSF, but one that is seen as important. By evaluating the financial results of MSF in comparison to other insurers aids in assessing and maintaining the financial security and stability of MSF as a workers' compensation insurer. In addition, MSF is a component unit of the State of Montana. As required in law the Legislative Audit Division (LAD) of the State of Montana conducts independent audits of financial statements of MSF presented in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). For the financial periods ending June 30, 2003 and 2002, MSF received an unqualified audit opinion from the LAD. The audited governmental financial statements and the related audit opinion are issued under separate cover. To obtain a copy of the full governmental financial statements, contact the Legislative Audit Division. The presentation of the statutory financial statements in this report differs from the governmental presentation basis (GASB). A financial reconciliation of surplus between the audited GASB financial statements and the audited statutory financial statements presented in this report is provided below.

The following is a Comparison of Statutory Accounting Ending Surplus to GASB Ending Net Assets for the year ended June 30, 2003 (in 000's).

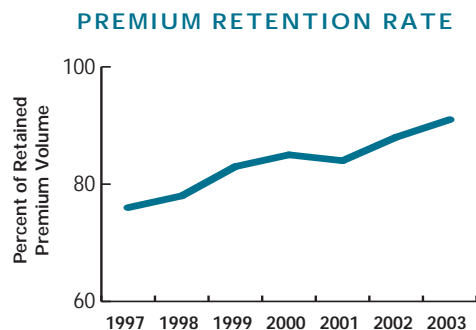
Statutory Accounting Surplus	\$121,599
Reconciling Items:	
Change in non-admitted assets	6,082
Change in investment value of bonds to fair market value	35,547
Change in investment value recognized for GASB	(720)
The change in net income between Statutory and GASB for:	
Deferred acquisition costs	596
Reversal of prior adjustment	(10)
Governmental Accounting (GASB) Net Assets	\$163,094



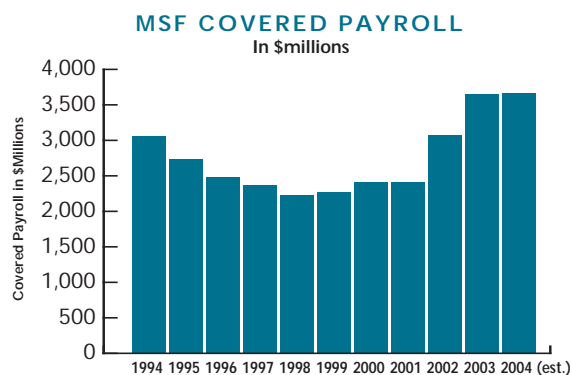
While prices have been rising since 2000, rates are still 28% below their 1995 level. Medical inflation and higher utilization are putting upward pressure on prices, making safety and accident prevention a key element for controlling costs.



After remaining relatively level, claim severity is trending upward. This is reflected by the rise in medical expenditures as well as an up tick in frequency.



Our growth in premium retention coincides with the increases reported in our biannual customer satisfaction survey. Retention now exceeds 90%.



The rapid growth of the past few years is anticipated to level off in 2004. With over 28,000 policies served, MSF is the insurance carrier of choice for the vast majority of Montana businesses.



QUICK FACTS

AS OF JUNE 30, 2003

Earned Premium	\$117,776,580
Number of Policies Served	28,190
Total Number of Claims Processed	13,929
Number of FTEs	259
Investment Income	\$26,799,946
Net Income (Loss)	(\$37,462,944)
Reserve to Surplus Ratio (after dividend)	3.40
Premium to Surplus Ratio (after dividend)	0.97
Equity	\$121,599,417
Total Fraud Savings Since Inception	\$16,351,072
Compensation Benefits Paid	\$36,574,303
Medical Benefits Paid	\$46,737,792
Total Benefits Paid	\$83,312,095

board of directors



Mark Cole
Shelby



Derek Grewatz
Missoula



Ed Henrich
Anaconda



Laurence Hubbard
Ex-Officio, Helena



Herbert Leuprecht
Butte



Mardi Madsen
Billings



Jack Morgenstern
Lewistown



Derek Scoble
Clancy

executive team



Left to right:

Mark Barry, Vice President Corporate Support

Harold Williams, Chief Information Officer

Nancy Butler, General Counsel

Peter Strauss, Vice President Insurance Operations Support

Layne Kertamus, Vice President Insurance Operations

Sherrie Handel, Special Assistant to the President

HIGHLIGHTS

For the 5th consecutive year, MSF awarded a dividend. Since 1998, \$31 million has been returned to deserving policyholders with superior safety records.

Governor Martz appointed Ed Henrich (Anaconda), Mardi Madsen (Billings), Jack Morgenstern (Lewistown) and Derek Scoble (Clancy) to the MSF Board of Directors.

Laurence Hubbard was selected to be the new President/CEO of MSF in May 2003. He previously served as vice president of insurance operations, and has been with MSF since 1989.

Efforts of the Special Investigations Unit (Fraud) resulted in a 22% increase in funds recovered over the previous year.

Montana State Fund's newsletter *Perspectives* was distributed to over 30,000 policyholders, providers and agents each quarter during the year.

The 2003 legislature affirmed our commitment to provide charitable grants through our ACE (Assisting Charitable Endeavors) program. The ACE program makes matching funds available to qualifying non-profit organizations and associations that contribute to both the safety and community well being in our state. A total of \$17,135 was awarded to 9 worthy projects.

Our Scholarship program assists children and spouses of workers who were fatally injured in a work-related accident. Eleven scholarships were awarded, benefitting those who are most affected by such a significant loss.

Over 400 Montana employers attended MSF safety trainings held in 26 different communities throughout the state.

Our Safety Management Consultants visited 1,597 policyholders in the past year; a 16% increase over the previous year.

